OFFICE OF THE CITY CONTROLLER

CITY OF HOUSTON
INTEROFFICE CORRESPONDENCE

TO: Mayor Bill White
City Council Members

From: Annise D. Parker
City Controller

Date: November 4, 2005

Subject: September 2005 Financial Report

Attached is the Monthly Financial and Operations Report for the period ending September 30, 2005.

GENERAL FUND

We currently project a $7.5 million shortfall for the General Fund for Fiscal Year 2006, or $1 million more than last month.

Our revenue projections increased by a net of $1.4 million. This figure takes into account city council's decision to cut the property tax rate by a ¼-cent, or $2.4 million, as well as a $3 million increase in gas franchise fees caused by updated projections from CenterPoint Energy and $850,000 in higher than expected sales tax receipts for July and August.

Our expenditure projections increased by a net $2.4 million. The increase is attributed to a $5.4 million in higher energy costs for the Building Services and Solid Waste Departments and a $900,000 increase in Municipal Courts that is due to delays in implementation of the new computer system. Offsetting these increases are decreases of $1.2 million in General Government and $2.7 million in health benefits and other personnel expenses due to lower than budgeted staffing levels at HPD.

ENTERPRISE FUNDS

There are no significant changes to report for the Aviation and Convention and Entertainment Departments.

Operating Income for the Combined Utility System increased by a net of $14.7 million. This is due to $11.3 in decreased personnel costs that are attributed to approximately 340 vacant FTEs and $4.6 million in lower year-to-date spending on various contracts. This decrease is offset by an increase of $1.2 million in supplies due to projected increases in chemicals costs for water treatment.

There is a $1.9 million increase in non-operating revenues. This is primarily due to a $1.8 million decrease in CIP salary recovery revenue tied to delays in converting contract inspectors to city employees and a decrease in HAWC expenses of $3.7 million that resulted from the use of bond proceeds, instead of budgeted funds, to make debt payments.

COMMERCIAL PAPER AND BONDS

The City's practice has been to maintain no more than 20% of the total outstanding debt for each type of debt in a variable rate structure. At month-end, the ratio for each type of outstanding debt was:

General Obligation	19.3%
Combined Utility System	17.5%
Aviation	21.7%
Convention and Entertainment	28.0%

SWAP REPORT

The City's Swap Policy specifies that the City will track and report on the financial implications of its swap agreements on a quarterly basis. The report is to include a summary of key terms of the agreements, mark-to-market value, exposure to counterparties, credit ratings of counterparties or guarantors, and any collateral posted as a result of the Swap agreements. The report for September 30, 2005 is included as an attachment to this letter.

Respectfully submitted,

Annise D. Parker

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City Controller

City of Houston, Texas
Swap Agreements Disclosure
September 30, 2005

I. General Obligation Swap

On February 20, 2004 the City entered into a basis swap referred to as a synthetic reduced variance coupon swap with RFPC, LLC ("RFPC"). This was a negotiated transaction.

Objective. The objective of the swap is for the City to reduce its fixed rate debt service costs through a swap structure that takes on basis risk.

Terms. On a notional value of $200,000,000, the City pays an amount equal to 5% plus the tax-exempt market standard BMA Index rate divided by .667 minus the taxable six-month US Dollar LIBOR rate minus a constant of 69 basis points, up to a maximum of 10%. The City receives a fixed rate of 5% from RFPC. Because the two 5% fixed rates offset one another, the City is effectively making payments based on BMA and receiving payments based on LIBOR plus a fixed spread. The variable rate is fixed for each budget period. The agreement is effective from March 1, 2004 to March 1, 2025. Starting in fiscal year 2017, the notional value of the swap declines as the principal amount of the associated debt is repaid in varying amounts until the debt is retired in 2023.

Receipts. Based on the initial agreement, the City received $500,000 on March 1, 2005, representing debt service savings of 50 basis points (0.5%) on the underlying bonds. Receipts for fiscal year 2006 will total $499,000, representing a savings of 25 basis points. The first semi-annual payment for fiscal year 2007 will be $258,000, representing a savings of 26 basis points. Future payments will be received or made every six months based on the indexes for the prior budget period.

Fair value. The fair value of the swap was negative $3,717,000 on September 30, 2005. The value was calculated using the zero coupon method.

Credit risk. As of this date, the City was not exposed to credit risk because the swap had a negative fair value. However, if interest rates change and the fair value of the swap becomes positive, the City will be exposed to credit risk on the swap in the amount of its fair value. RFPC has not been rated by the rating agencies. To mitigate the potential credit risk, the City required RFPC to purchase a surety bond from Ambac Assurance Corporation, a AAA rated insurance company. Ambac also insures the City's obligations under the swap. Should Ambac's rating decline in the future, RFPC will be required to post collateral for the City's benefit.

Interest rate risk. The City has an exposure to interest rate risk because it is paying a variable rate on the swap. However, this risk is mitigated because the payment formula has a BMA-based variable component that is offset by subtracting a LIBOR variable component.

Basis risk. The City is exposed to basis risk based on changes in the relationship between the taxable six-month US Dollar LIBOR index and the tax-exempt BMA index. The City entered into the swap in anticipation of savings that would be produced based on the historical trading patterns of BMA and LIBOR in different interest rate, tax, and economic environments over the past two decades. If, however, future trading patterns prove to be significantly different from historical ones, the City's anticipated savings could fail to materialize, and it could be exposed to additional costs. Among the factors that could cause this trading relationship to change would be a major reduction in marginal income tax rates, repeal of the tax-exemption for municipal bond interest, or other changes in federal policy that would reduce the benefit that municipal bonds currently enjoy in comparison to taxable investments.

Termination risk. The City may terminate the swap for any reason. RFPC may terminate the swap if both the City and the City's insurer fail to perform under the terms of the contract. If the swap has a negative fair value at the time of termination, the City will be liable to RFPC for that payment. The City's termination risk is significantly mitigated by a provision in the swap agreement that allows the City to make the termination payment in equal annual installments from time of termination up to the termination date of the agreement in 2025.

II. Combined Utility System Swaps

On June 10, 2004 the City entered into three pay-fixed, receive-variable rate swap agreements with identical rates. The City pre-qualified six firms to submit competitive bids on the swap. The three firms selected all matched the lowest fixed rate bid of 3.78%.

Objective. The objective of the swaps is to protect against the potential of rising interest rates associated with the City's Combined Utility System 2004B auction rate variable interest bonds and to achieve a lower fixed rate than the market rate for traditional fixed rate debt at time of issuance of the 2004B Bonds.

Terms. The notional amounts of the swap agreements total $653,325,000, the principal amount of the associated 2004B Bonds. The City's swap agreements contain scheduled reductions to outstanding notional amounts that follow anticipated payments of principal of the 2004B Bonds in varying amounts during the years 2028 to 2034.

Under the terms of the swaps, the City will pay a fixed rate of 3.78% and receive a floating rate equal to 57.6% of One-Month US Dollar LIBOR plus 37 basis points. All agreements were effective June 10, 2004, the date of issuance of the 2004B Bonds. The termination date is May 15, 2034.

Receipts and Payments. The City earned $3.97 million in swap receipts for its Combined Utility System, Series 2004B swap, and it paid $3.83 million interest on the underlying auction rate securities for the quarter ended September 30, 2005. The contractual rate for the City's swap payment is 3.78%. The average effective rate for the 2004B bonds, including interest for the Series 2004B variable rate bonds, the City's swap payments, and its dealer and auction fees, reduced by swap receipts, was 3.95%. In contrast, the fixed rate the City paid on its Combined Utility System Series 2004A fixed rate bonds, which have a comparable maturity, was 5.08%.

Fair value. Because interest rates have changed, the swaps had a total negative fair value of $57,526,000 on September 30, 2005. This value was calculated using the zero-coupon method.

Credit risk. As of this date, the City was not exposed to credit risk because the swaps had a negative fair value. However, should interest rates increase and the fair value of the swap become positive, the City would be exposed to credit risk on the swap in the amount of its fair value. The City's swap policy generally requires that swap counterparties be rated double-A or better by at least one nationally recognized rating agency. As of this date, the ratings of the three swap counterparties all met this standard (see below). Also, under the agreements, if a counterparty's credit rating falls below double-A, collateral must be posted in varying amounts depending on the credit rating and swap fair value. No collateral has been required to date.

Counterparty	Notional Amount	Fair Value	Counterparty Credit Rating (Moody's/S&P/Fitch)
Goldman Sachs Capital Markets Inc.	$ 353,325,000	$ (31,110,000)	Aa3 /A+ /AA-
Bear Stearns Financial Products Inc.	150,000,000	(13,208,000)	Aaa / AAA / --
UBS AG	150,000,000	(13,208,000)	Aa2 /AA+ /AA+
	$ 653,325,000	$ (57,526,000)	

Basis risk. The City is exposed to basis risk on the swaps because the variable payment received is based on a taxable index rather than the tax-exempt rate the City pays on the bonds. Should the relationship between taxable LIBOR and tax-exempt BMA move to convergence (because of reductions in tax rates, for example), the expected cost savings may not be realized. At September 30, 2005 the average interest rate of the tax-exempt auction rate bonds equaled the associated LIBOR-based rate of the swap receipts at 2.54%.

Termination risk. The City may terminate for any reason. A counterparty may terminate a swap if the City fails to perform under the terms of the contract. The City's on-going payment obligations under the swap (and to a limited extent, its termination payment obligations) are insured, and counterparties cannot terminate so long as the insurer does not fail to perform. If a swap is terminated, the associated variable-rate bonds would no longer carry synthetic fixed interest rates. Also, if at the time of the termination the swap has a negative fair value, the City would be liable to the counterparty for a payment equal to the swap's fair value.